Supreme Court, U.S.
FILED
95-917 DEC 11 1995
OFFICE OF THE CLERK

No. _____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

JOSEPH W. ROBERTSON, RICHARD D. SUTTON, JOSEPH P. IARIA, FRANK J. EWART, JACK MEYERS, LEONARD G. LOMELL, JOHN C. FELLOWS, JR., DR. RAYMOND A. TAYLOR, and ESTATE OF FRANK EWART, John Ewart, Administrator,

Petitioners,

v.

CHARLES MOENCH, in his own right and on behalf of all others similarly situated, and on behalf of the Statewide Bancorp Employee Stock Option Plan,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit

---

PETITION FOR A WRIT OF CERTIORARI

CHRISTOPHER J. CAREY
LISA W. SANTOLA
TOMPKINS, MCGUIRE & WACHENFELD
100 Mulberry Street
Newark, NJ 07102
(201) 622-3000

ROBERT N. ECCLES
(Counsel of Record)
KAREN M. WAHLE
O'MELVENY & MYERS
555 Thirteenth Street, NW
Washington, DC 20004
(202) 383-5300

Counsel for Petitioners

QUESTION PRESENTED FOR REVIEW

1. Whether the court below erred in holding that fiduciaries of an employee stock ownership plan ("ESOP") have a duty under the Employee Retirement Income Security Act of 1974 to consider investing the ESOP's assets in investments other than securities issued by the ESOP's corporate sponsor?

PARTIES TO THE PROCEEDING

All parties to the proceedings below are parties before this Court. The named respondent is Charles Moench who represents a class consisting of all individuals who were participants or beneficiaries of the Statewide Bancorp Employee Stock Ownership Plan sponsored by Statewide Bancorp, Toms River, New Jersey from October 20, 1988 to December 17, 1993.

The petitioners are Joseph W. Robertson, Richard D. Sutton, Joseph P. Iaria, Frank J. Ewart, Jack Meyers, Leonard G. Lomell, John C. Fellows, Jr., Dr. Raymond A. Taylor, and Estate of Frank Ewart, John Ewart, Administrator.

TABLE OF CONTENTS

QUESTION PRESENTED FOR REVIEW i

PARTIES TO THE PROCEEDING ii

TABLE OF AUTHORITIES v

PETITION FOR A WRIT OF CERTIORARI 1

OPINIONS BELOW 2

JURISDICTION 2

STATUTORY PROVISIONS INVOLVED 2

STATEMENT OF THE CASE 5

REASONS FOR GRANTING THE WRIT 9

I. Congress Intended to Encourage ESOPs, Not Discourage Them Through an Overreaching Application of ERISA's Fiduciary Rules . . 10

II. The Lower Courts are in Confusion Over Application of ERISA's Fiduciary Rules to ESOPs 13

III. The Decision Below is in Error and Warrants Review by This Court 18

CONCLUSION 23

APPENDIX

Appendix A --
Opinion of the Court of Appeals for the Third Circuit (August 10, 1995) 1a

Appendix B --
Judgment of the Court of Appeals for the Third Circuit (August 10, 1995) 47a

Appendix C --
Memorandum and Order of the District Court on Motion to Dismiss (August 20, 1993) 49a

Appendix D --
Order of the District Court Approving Class and Derivative Certification (December 20, 1993) . . 57a

Appendix E --
Memorandum and Order of the District Court on Cross-Motions for Summary Judgment (September 20, 1994) 60a

Appendix F --
Order of the Court of Appeals for the Third Circuit on Petition for Rehearing (September 12, 1995) 77a

TABLE OF AUTHORITIES

Cases **Page**

Bachelder v. Communications Satellite Corp.,
837 F.2d 519 (1st Cir. 1988) 15

Burud v. Acme Elec. Co.,
591 F. Supp. 238 (D. Alaska 1984) 16

Canale v. Yegen,
782 F. Supp. 963 (D.N.J. 1992) 16

Donovan v. Cunningham,
716 F.2d 1455 (5th Cir. 1983),
cert. denied, 467 U.S. 1251 (1984) 14, 15, 17

Eaves v. Penn,
587 F.2d 453 (10th Cir. 1978) 15

Elmore v. Cone Mills Corp.,
23 F.3d 855 (4th Cir. 1994) (*en banc*) 15

Ershick v. United Missouri Bank of Kansas City, N.A.,
705 F. Supp. 1482 (D. Kan. 1989),
aff'd, 948 F.2d 660 (10th Cir. 1991) 16-18

Hood v. Smith's Transfer Corp.,
762 F. Supp. 1274 (W.D. Ky. 1991) 15

TABLE OF AUTHORITIES (continued)

Page

Hozier v. Midwest Fasteners, Inc.,
908 F.2d 1155 (3d Cir. 1990) 22

Izzarelli v. Rexene Products Co.,
24 F.3d 1506 (5th Cir. 1994) 22

Kuper v. Iovenko,
66 F.3d 1447 (6th Cir. 1995) 19

Martin v. Feilen,
965 F.2d 660 (8th Cir. 1992),
cert. denied, 113 S. Ct. 979 (1993) 10-11, 20

Martin v. Harline,
15 Employee Benefits Cas. (BNA) 1138
(D. Utah 1992) 15

McDonald v. Pan American World Airways, Inc. Employee Stock Ownership Plan,
859 F.2d 742 (9th Cir. 1988) 15

Reich v. Valley National Bank of Arizona,
837 F. Supp. 1259 (S.D.N.Y. 1993) 15

Siskind v. Sperry Retirement Program,
47 F.3d 498 (2d Cir. 1995) 22

TABLE OF AUTHORITIES (continued)

Page

Sweeney v. Kroger,
773 F. Supp. 1266 (E.D. Mo. 1991) 15

United States v. Carlton,
114 S. Ct. 2018 (1994) 11

Statutes

Internal Revenue Code of 1954,
26 U.S.C. §§ 1 *et seq.*

26 U.S.C. § 133 11

26 U.S.C. § 401(a)(28) 20, 21

26 U.S.C. § 404(k) 11

26 U.S.C. § 1042 11

26 U.S.C. § 2057 20

26 U.S.C. § 4978 20

26 U.S.C. § 4978A 20

26 U.S.C. § 4980 20

TABLE OF AUTHORITIES (continued)

Page

Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001 *et seq.*

§ 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) . . . 13, 15

§ 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) 12

§ 404(a)(2), 29 U.S.C. § 1104(a)(2) 12

§ 406, 29 U.S.C. § 1106 12

§ 407(d)(6), 29 U.S.C. § 1107(d)(6) 6, 10

§ 408(e), 29 U.S.C. § 1108(e) 12, 14

§ 502(a)(2), 29 U.S.C. § 1132(a)(2) 8

§ 502(e), 29 U.S.C. § 1132(e) 8

Tax Reform Act of 1976, Pub. L. No. 94-455 90 Stat. 1590 (1976) 11, 13

Tax Reduction Act of 1975 11

TABLE OF AUTHORITIES (continued)

Page

Legislative History and Regulations

H.R. Conf. Rep. No. 93-1280, *reprinted in* U.S. Code Cong. & Admin. News 5038 11-12

129 Cong. Rec. S16629, S16636 (Daily ed. Nov. 7, 1983) 10

26 C.F.R. § 54.4975-11(a)(5) 21

26 C.F.R. § 54.4975-11(b) 6, 10, 21

Miscellaneous

Report of the Subcommittee on Employee Stock Ownership Plans, Committee on Employee Benefits, ABA Section of Tax'n, *ESOPs Foibles*, 31 Tax Law. 561 (1978) 17

Fiduciary Aspects of Employee Stock Ownership Plan Investments in Employer Securities, 23 Real Prop. & Prob. Trust J. 575 (Winter 1988) 17

Employee Stock Ownership Plans 1995 Yearbook (Robert W. Smiley, Jr., *et al.*, eds., 1994) 22

No. _____

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1995

JOSEPH W. ROBERTSON, RICHARD D. SUTTON, JOSEPH P. IARIA, FRANK J. EWART, JACK MEYERS, LEONARD G. LOMELL, JOHN C. FELLOWS, JR., DR. RAYMOND A. TAYLOR, and ESTATE OF FRANK EWART, John Ewart, Administrator,

Petitioners,

v.

CHARLES MOENCH, in his own right and on behalf of all others similarly situated, and on behalf of the Statewide Bancorp Employee Stock Option Plan,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

Joseph W. Robertson, Richard D. Sutton, Joseph P. Iaria, Frank J. Ewart, Jack Meyers, Leonard G. Lomell, John C. Fellows, Jr., Dr. Raymond A. Taylor, and the Estate of Frank Ewart, John Ewart, Administrator, respectfully request that a writ of certiorari be issued to review the

judgment of the United States Court of Appeals for the Third Circuit entered on August 10, 1995.

OPINIONS BELOW

The opinions of the United States District Court for the District of New Jersey are not reported. (App. 49a, 60a.)[1] The opinion of the United States Court of Appeals for the Third Circuit was issued on August 10, 1995 and is reported at 62 F.3d 553. (App. 1a.) The order of the United States Court of Appeals for the Third Circuit denying the petition for rehearing is unreported. (App. 77a.)

JURISDICTION

The court of appeals entered its judgment on August 10, 1995. Respondents timely sought rehearing by the Third Circuit, and that request was denied on September 12, 1995. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 404(a)(1) of the Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. § 1104(a)(1), provides:

---

[1] "App." refers to the Appendix to this Petition. "3d Cir. App." refers to the Appendix filed with the court of appeals.

Subject to sections 403(c) and (d), 4042, and 4044 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and --

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and Title IV.

ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2), provides:

In the case of an eligible individual account plan (as defined in section 407(d)(3) of this title), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition

> or holding of qualifying employer real property or qualifying employer securities (as defined in section 407(d)(4) and (5) of this title).

ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6), provides:

> The term 'employee stock ownership plan' means an individual account plan --
>
> > (A) which is a stock bonus plan which is qualified, or a stock bonus plan and money purchase plan both of which are qualified, under section 401 of title 26, and which is designed to invest primarily in qualifying employer securities, and
> >
> > (B) which meets such other requirements as the Secretary of the Treasury may prescribe by regulation.

ERISA § 408(e), 29 U.S.C. § 1108(e), provides:

> Sections 406 and 407 of this title shall not apply to the acquisition or sale by a plan of qualifying employer securities (as defined in section 407(d)(5) of this title) or acquisition, sale or lease by a plan of qualifying employer real property (as defined in section 407(d)(4) of this title) --
>
> > (1) if such acquisition, sale, or lease is for adequate consideration (or in the case of a marketable obligation, at a price not less favorable to the plan than the price determined under section 407(e)(1) of this title),

(2) if no commission is charged with respect thereto, and

(3) If --

(A) the plan is an eligible individual account plan (as defined in section 407(d)(3) of this title), or

(B) in the case of an acquisition or lease of qualifying employer real property by a plan which is not an eligible individual account plan, or of an acquisition of qualifying employer securities by such a plan, the lease or acquisition is not prohibited by section 407(a).

26 C.F.R. §54.4975-11(b) provides:

Plan designed to invest primarily in qualifying employer securities. A plan constitutes an ESOP only if the plan specifically states that it is designed to invest primarily in qualifying employer securities. Thus, a stock bonus plan or a money purchase pension plan constituting an ESOP may invest part of its assets in other than qualifying employer securities. Such plan will be treated the same as other stock bonus plans or money purchase pension plans qualified under section 401(a) with respect to those investments.

STATEMENT OF THE CASE

Statewide Bancorp ("Statewide") was organized as a bank holding company in 1982. (3d Cir. App. 329.) In January 1986, Statewide established an Employee Stock

Ownership Plan (the "Plan"). (App. 6a.) All employee contributions to the Plan were voluntary. An amount equal to 50 percent of the voluntary contribution was matched by the employer. In addition, optional employer contributions could be authorized by Statewide's Board of Directors at the end of each plan year. (App. 8a.)

As required by ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6), and 26 C.F.R. § 54.4975-11(b), the plan documents stated that the "primary investment of the Plan shall be Statewide Bancorp Common Stock." (App. 61a.) Employees were informed by letter accompanying the initial distribution of the Summary Plan Description that the "Plan will be invested solely in Statewide Bancorp stock." (3d Cir. App. 296.) Similarly, the Plan Prospectus dated July 7, 1986 stated that "[a]ll Employer contributions are currently intended to be made in the form of shares of the Company's common stock [and] cash which is in the Participants' Employee Contribution Accounts will be used to purchase shares of Common stock, if available." (3d Cir. App. 315.) The Summary Plan Description warned that "[e]ach individual Employee's account will experience gains or losses according to the performance of the investments held by the Plan" (3d Cir. App. 174), and that the "Plan . . . does not provide for a guaranteed benefit at retirement." (App. 71a.)

Petitioners are the individuals who at various times were members of the Salary and Benefits Committee ("Plan Committee" or "Committee"), which was the named fiduciary of the Plan. The Plan Committee had the responsibility "to administer the Plan" and was given discretion to

interpret the terms of the Plan and control its administration. (App. 6a-7a.) Until early 1991, the Plan Committee remitted all monthly contributions to the Plan's trustee (Statewide's subsidiary, the First National Bank of Toms River, New Jersey, or "Trustee") for the purchase of such stock. (App. 9a-10a.)

Statewide began experiencing financial difficulties in 1989. (App. 4a.) Federal regulatory authorities became involved and, for the following two years, expressed concerns to Statewide's Board of Directors over problems with Statewide's portfolio and financial condition, requiring Statewide to greatly increase its allowances for loan losses. (3d Cir. App. 89.) The price of Statewide common stock began to fall precipitously, from $18.25 in July 1989 to $6.00 by July 1990. (App. 62a.)

Throughout this time period, the Plan Committee continued to invest all Plan assets in Statewide common stock. (App. 8a.) Jack Breda, an executive of the Trustee, testified that he became concerned that perhaps the Plan contributions should be invested elsewhere and discussed this concern with Statewide's CEO. (App. 8a-9a.) The CEO took this concern to Statewide's Board of Directors who, on behalf of the Plan's sponsor, had the power to amend the Plan. The Board of Directors rejected a recommendation to permit Plan investment in vehicles other than Statewide stock because "the original intent of the plan was to invest [in] Statewide Bancorp stock and really nothing had changed to change their minds." (App. 8a, 3d Cir. App. 120-21.)

By May 1991, the price of Statewide common stock had dropped to 25 cents per share. (App. 4a.) The Trustee

decided to cease investing in Statewide common stock and placed all of the ESOP assets in money market accounts. (App. 9a-10a.) Shortly after, on May 22, 1991, federal banking authorities closed Statewide's operating bank subsidiary. On May 23, Statewide filed a voluntary petition under Chapter 11 of the bankruptcy code. (App. 6a, 3d Cir. App. 53a.)

On November 16, 1992, this action was filed in the United States District Court for the District of New Jersey against the members of the Plan Committee by respondent Charles Moench, a former employee of Statewide and a participant in the Plan. (App. 10a.) This complaint was later amended on September 20, 1993 asserting, *inter alia*, a claim for breach of fiduciary duty under ERISA § 502(a)(2), 29 U.S.C. § 1132(a)(2). Plaintiff invoked the district court's jurisdiction under ERISA § 502(e), 29 U.S.C. § 1132(e), and under 28 U.S.C. § 1331. (App. 11a-12a.)

Respondent claimed that the Committee had breached its fiduciary obligations under ERISA by investing Plan assets in Statewide stock. The district court granted defendants' motion for summary judgment on this claim, holding that the plan documents mandated that the Committee invest the ESOP assets solely in Statewide stock. (App. 11a-12a.)

The Court of Appeals for the Third Circuit reversed the grant of summary judgment, finding that -- despite the fact that the purpose of the Plan was expressly stated to be investment in Statewide stock (App. 29a-32a) -- the terms of the Plan did not "absolutely require[ ]" the fiduciary to invest in employer securities but "more than simply

permitted" it. (App. 41a.) Although stating that an ESOP fiduciary who invests the assets in employer stock "is entitled to a presumption that it acted consistently with ERISA by virtue of that decision," that presumption could be rebutted by introducing evidence that "owing to circumstances not known to the settlor and not anticipated by him," the purchase of employer securities would defeat the purpose of the trust. (App. 41a.) Despite the fact that the Board of Directors of Statewide -- the plan sponsor -- had as recently as May 1991 reconfirmed that the purpose of the Plan was to purchase and hold Statewide stock, the Third Circuit found it possible that "the precipitous decline in the price of Statewide stock, as well as the Committee's knowledge of its impending collapse . . . [may have] changed circumstances to such an extent that the Committee properly could effectuate the purposes of the trust only by deviating from the trust's direction." (App. 43a.) The court of appeals therefore reversed the district court's grant of summary judgment and remanded the case for trial to the district court. (*Id.*)

REASONS FOR GRANTING THE WRIT

In enacting legislation to authorize and promote the establishment of ESOPs, Congress expressed a national policy that employees be encouraged to share, through ESOP stock ownership, in the fortunes of their employers. Congress envisioned that ESOPs would provide necessary funds for capital growth and tie employees' interests more closely to those of employers while allowing employees to

build their personal capital for retirement and other purposes.

The decision below frustrates that Congressional intent by holding that ESOP fiduciaries may be sued under ERISA for making the very investment in employer securities that ESOPs are designed to make. If ESOP fiduciaries are subject to suit for investing in employer securities rather than in other investments, then the fundamental purpose of ESOPs will be overridden. In order to resolve this central question in the administration of ESOPs and to end the confusion and conflict among the lower courts over how ERISA's fiduciary rules should apply to investment decisions by ESOP fiduciaries, review by this Court is warranted.

I. Congress Intended to Encourage ESOPs, Not Discourage Them Through an Overreaching Application of ERISA's Fiduciary Rules

Under ERISA and related provisions of the Internal Revenue Code, the term employee stock ownership plan, or ESOP, refers to a tax-qualified plan that "specifically states that it is designed to invest primarily in qualifying employer securities," typically, the stock of the ESOP's sponsoring employer. 26 C.F.R. § 54.4975-11(b); *see also* ERISA § 407(d)(6). Congress intended that ESOPs, as vehicles for employee investment in employer stock, would serve not only to provide retirement income to employees but also as a "'technique of corporate finance' that would encourage employee ownership." *Martin v. Feilen*, 965 F.2d 660, 664 (8th Cir. 1992), *cert. denied*, 113 S. Ct. 979 (1993), *quoting*

129 Cong. Rec. S16629, S16636 (Daily ed. Nov. 7, 1983) (statement of Sen. Long).[2]

To encourage the establishment and maintenance of ESOPs, Congress has, through the years since ERISA's passage, enacted various tax incentives beyond those that apply to tax-qualified retirement plans generally. These have included various tax credits for contributions to certain types of ESOPs (*see* Tax Reduction Act of 1975 § 301(d)(6), since repealed); exemption of 50 percent of a qualified lender's interest income from loans made to finance certain ESOP acquisitions of employer stock (26 U.S.C. § 133); deferral of capital gains taxes for certain sales by shareholders of privately held corporations who sell shares to an ESOP and invest the proceeds in "qualifying replacement property" (26 U.S.C. § 1042); favorable estate tax treatment for certain stock sales to ESOPs (*see United States v. Carlton*, 114 S. Ct. 2018 (1994)); and deductibility of dividends paid on stock held by an ESOP (26 U.S.C. § 404(k)).

---

[2] *See also* Tax Reform Act of 1976, Pub. L. No. 94-455, § 803(a), 90 Stat. 1590 (1976):

> The Congress, in a series of laws . . . and this Act has made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free private enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees.

At the same time as Congress sought to encourage ESOPs, it gave ESOPs and other "eligible individual account plans" specific exceptions from certain of ERISA's rules governing fiduciary duties. Thus, the definitive Conference Report on ERISA stated that:

> If securities are qualifying employer securities they generally can be acquired or held notwithstanding the prohibited transaction rules, if acquisition is for adequate consideration and no commission is charged and if acquisition is allowed by the employer securities rules. However (except as noted above for eligible individual account plans), acquisition and holding of these assets must also meet the rules of prudence, diversification, etc.

H.R. Conf. Rep. No. 93-1280 at 320, 93d Cong., 2d Sess. 297 (1973), *reprinted in* 3 Senate Subcomm. on Labor, Legislative History of ERISA 4518, 4587 (Comm. Print 1976) *and in* 1974 U.S. Code Cong. & Admin. News 5038, 5100.

To provide expressly for this special treatment of ESOPs, Congress enacted ERISA § 408(e), 29 U.S.C. § 1108(e), which excepts the acquisition and sale of qualifying employer securities under certain conditions from ERISA's prohibited transaction rules in ERISA § 406, 29 U.S.C. § 1106. It also enacted ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2), which provides that eligible individual account plans are not subject to the general fiduciary duty of ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C), to diversify plan investments and are not subject to the duty of

prudence in § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B), to the extent it requires diversification of investments.

Despite its desire to apply fiduciary standards in some measure to the administration of ESOPs, Congress remained resolute that the application of such standards not frustrate the overriding goal of employee ownership. Most notably, in enacting additional incentives to the formation of ESOPs in 1976, Congress sharply criticized federal agency actions that sought to treat ESOPs according to fiduciary standards applicable to other retirement plans. Thus, the Tax Reform Act of 1976 stated:

> The Congress is deeply concerned that the objectives sought by [a series of laws passed to encourage employee stock ownership, including ERISA] will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of the employee trusts and employers to take necessary steps to implement the plans, and which otherwise block the establishment and success of these plans.

Pub. L. No. 94-455, § 803(h), 90 Stat. 1590 (1976)

II. The Lower Courts are in Confusion Over Application of ERISA's Fiduciary Rules to ESOPs

Given the varied goals of Congress in authorizing ESOPs, it is not surprising that the lower courts have diverged in their application of ERISA's fiduciary rules to

ESOPs. As the court summed up the dilemma in *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984):

> On the one hand, Congress has repeatedly expressed its intent to encourage the formation of ESOPs by passing legislation granting such plans favorable treatment, and has warned against judicial and administrative action that would thwart that goal. Competing with Congress' expressed policy to foster the formation of ESOPs is the policy expressed in equally forceful terms in ERISA: that of safeguarding the interests of participants in employee benefit plans by vigorously enforcing standards of fiduciary responsibility.

Id. at 1466 (citations omitted).

Donovan v. Cunningham involved one of the situations in which ERISA's fiduciary rules clearly were intended to apply to ESOPs, *i.e.*, in determining whether an ESOP paid or received a fair price in acquiring or selling employer securities. There, the Secretary of Labor challenged the decision of a fiduciary committee that administered an ESOP to purchase employer stock at inflated prices from one of the Committee members. 716 F.2d at 1458. As noted above, § 408(e) of ERISA, expressly permits such purchases provided, among other things, that the purchase is for no more than "adequate consideration." In holding that the defendant fiduciaries had violated their fiduciary duties by paying in excess of "adequate consideration" for the stock, the *Donovan v. Cunningham* court incorporated into the

definition of "adequate consideration" the test developed under the case law for determining compliance with the prudent person standard of conduct in ERISA § 404(a)(1)(B). *Id.* at 1467. Similar holdings have been reached by other courts addressing the prudence of the price at which the ESOP acquires or sells employer stock.[3]

Thus, there is general consensus among the lower courts regarding the applicability of ERISA's fiduciary rules to decisions involving the price paid or received by an ESOP for employee stock. Likewise, outside of the investment context, there is no controversy that ERISA's rules imposing fiduciary duties in plan administration -- including fiduciary duties of disclosure[4] and fiduciary duties in handling benefit claims[5] -- apply equally to ESOP administrators as they do to administrators of other ERISA plans.

Where, however, no issue is presented regarding the administration of an ESOP and no challenge is raised to the

---

[3] *See Eaves v. Penn*, 587 F.2d 453, 459 (10th Cir. 1978); *Reich v. Valley Nat'l Bank of Arizona*, 837 F. Supp. 1259, 1273 (S.D.N.Y. 1993); *Martin v. Harline*, 15 Employee Benefits Cas. (BNA) 1138, 1151-52 (D. Utah 1992); *Hood v. Smith's Transfer Corp.*, 762 F. Supp. 1274, 1294 (W.D. Ky. 1991).

[4] *See, e.g., Elmore v. Cone Mills Corp.*, 23 F.3d 855 (4th Cir. 1994) (*en banc*); *Sweeney v. Kroger*, 773 F. Supp. 1266 (E.D. Mo. 1991).

[5] *See, e.g., Bachelder v. Communications Satellite Corp.*, 837 F.2d 519 (1st Cir. 1988); *McDonald v. Pan American World Airways, Inc. Employee Stock Ownership Plan*, 859 F.2d 742 (9th Cir. 1988).

price paid or received by the ESOP for its employer stock, the courts have diverged in their application of fiduciary rules to ESOP investment decisions. As the court below aptly stated, it is as to these decisions -- particularly as to decisions regarding whether to invest in employer securities -- that the conflict between the statutory goals related to ESOPs "becomes particularly stark." (App. 36a.) A number of courts have endorsed, at least in principle, the absolutist view -- consistent with the position advanced by the Secretary of Labor as *amicus curiae* in the court below -- that the general fiduciary duties of ERISA override any special treatment of ESOPs and fully apply to all ESOP investment decisions.[6]

This position has been criticized by commentators and rejected by other courts as inconsistent with the fundamental purpose of ESOPs. In *Ershick v. United Missouri Bank of Kansas City, N.A.*, 948 F.2d 660 (10th Cir. 1991), ESOP participants brought suit against an ESOP trustee who, similar to the facts of this case, had maintained the investment of all of the ESOPs assets in employer stock during a period of great price decline in that stock. The district court rejected this claim, finding that the trustee was required to invest in employer stock in order to carry out the purpose of the ESOP and stating that:

> ERISA requires trustees to carry out the aims of the plans they administer; trustees who disregard

---

[6] *See, e.g., Canale v. Yegen*, 782 F. Supp. 963, 967-68 (D.N.J. 1992); *Burud v. Acme Elec. Co.*, 591 F. Supp. 238, 246-48 (D. Alaska 1984).

> the stated purpose of an employee stock ownership plan to invest primarily in employer securities and who instead invest in non-employer investments may be liable for breach of fiduciary duties.

948 F.2d at 665, *citing* 705 F. Supp. 1482 (D. Kan. 1989). On appeal, judgment in favor of the trustee was affirmed. 948 F.2d at 669.

Consistent with *Ershick*'s analysis, expert commentary on ESOPs has decried the wholesale application of ERISA's fiduciary rules to ESOPs. As an American Bar Association subcommittee report stated: "To require an investment primarily in employer stock on one hand and then to question the prudence of the investment seems contradictory." Report of the Subcommittee on Employee Stock Ownership Plans, Committee on Employee Benefits, ABA Section of Tax'n, *ESOPs Foibles*, 31 Tax Law. 561, 576 (1978). Likewise, in *Fiduciary Aspects of Employee Stock Ownership Plan Investments in Employer Securities*, 23 Real Prop. & Prob. Trust J. 575 (Winter 1988), a leading practitioner in ESOP issues concluded that application of ERISA's prudence rule to ESOP investment decisions made no sense except where -- as in the *Donovan v. Cunningham* line of cases and unlike this case -- the question presented was whether the ESOP had overpaid for its employer stock or received too low a price for its sale.

III. The Decision Below is in Error and Warrants Review by This Court

The decision below only deepens the confusion and conflict over the application of ERISA's fiduciary rules to investment decisions by ESOP fiduciaries. As in *Ershick*, the threshold issue in this case is whether petitioners, as ESOP fiduciaries, had a duty under ERISA to consider investing the ESOP's assets in something other than stock of Statewide Bancorp. The district court, relying on its analysis of ERISA and of the documents governing the ESOP at issue, held that no such duty existed and granted summary judgment to petitioners. (App. 72a.)

The Court of Appeals for the Third Circuit reversed. The court disagreed with the district court's interpretation of the governing ESOP documents, finding that they required petitioners to invest ESOP assets only "primarily," not "exclusively," in Statewide Bancorp stock. (App. 33a.) The court rejected as inconsistent with Congressional intent concerning ESOPs the view advocated by respondent and his *amici*, including the Secretary of Labor, that ERISA's fiduciary rules apply wholesale to investment decisions by ESOPs. At the same time, the court created a new test for applying those rules to ESOP investments. The court held that an ESOP fiduciary who invests the assets of the plan in employer stock "is entitled to a presumption that it acted consistently with ERISA by virtue of that decision." (App. 41a.) However, plaintiffs may rebut that presumption by introducing evidence that "owing to circumstances not known to the settlor and not anticipated by him," the purchase of employer securities would defeat the purpose of the trust.

Id. "[I]n other words, the plaintiff must show that the ERISA fiduciary could not have believed reasonably that continued adherence to the ESOP's direction was in keeping with the settlor's expectations of how a prudent trustee would operate." (App. 41a-42a.)

Although the court's rejection of respondent's argument below is welcome, its introduction of yet another standard for measuring the conduct of ESOP fiduciaries adds to the confusion in the case law and subjects these fiduciaries unfairly to massive personal financial liability for faithfully implementing the ESOP's obvious and central purpose. Even under this standard, petitioners believe they will ultimately prevail on the merits of this case.[7] This Court's review is, however, necessary since the decision below is wrong, and ESOP fiduciaries, including petitioners, should not be subjected to liability for investing in employer securities where no question is raised about the price paid or received by the ESOP for the securities.

In enacting the provisions that relieve ESOP fiduciaries of any duty to diversify ESOP investments and permit the holding of 100 percent of plan assets in employer securities, the Congress that enacted ERISA intended to permit ESOPs to be fully invested in such securities. Indeed, one of the key distinctions made in ERISA between ESOPs and other "eligible individual account plans" that are

---

[7] In its recent decision in *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995), the Sixth Circuit adopted the standard enunciated by the court of appeals in this case and affirmed a judgment in favor of ESOP fiduciaries similarly situated to petitioners here.

permitted to invest in employer securities is that ESOPs are *required* to invest in such securities. As the very name of an ESOP suggests, the purpose of an ESOP is "employee stock ownership" of the ESOP's sponsoring employer.

Moreover, when the question of non-diversification of ESOP assets was raised in subsequent Congresses, Congress enacted a requirement for election of limited diversification of ESOP assets by certain employees aged 55 or older. *See* 26 U.S.C. § 401(a)(28). Thus, when Congress wanted to mandate that ESOP assets be invested other than in employer securities, it changed the law to do so. Consistent with its desire that ESOPs otherwise remain essentially invested in employer securities, Congress enacted, as part of the many tax incentives provided to encourage ESOPs, excise tax penalties on amounts transferred to ESOPs on various tax-favored bases that did not thereafter remain invested in employer securities. *See* 26 U.S.C. § 4978 (generally imposing an excise tax if an ESOP disposes of employer securities within three years after their acquisition under 26 U.S.C. § 1042); 26 U.S.C. § 4978A (imposing an excise tax if an ESOP disposes of employer securities within three years of an acquisition under 26 U.S.C. § 2057); 26 U.S.C. § 4980 (excepting from an excise tax on a reversion of surplus pension assets amounts transferred to an ESOP and used in connection with acquisition of employer securities, provided those securities remain in the plan until distribution to participants).

As the court noted in *Martin v. Feilen*, 965 F.2d 660, 664 (8th Cir. 1992), *cert. denied*, 113 S. Ct. 979 (1993), while policy criticisms can and have been made

about ESOPs and their non-diversification of assets, "that is a question for Congress." Where Congress has spoken and permitted ESOP assets to be non-diversified and fully invested in employer securities, the courts should not undo that Congressional intent by the back-door imposition of general fiduciary duties.

Nor can the decision below be justified by the court's finding that the ESOP at issue here required that assets be only "primarily" not "exclusively" invested in employer securities. (App. 32a.) As noted above, definitive regulations governing ESOPs expressly require that an ESOP "specifically state[ ]" that it is designed to invest "primarily" in employer securities. *See* 26 C.F.R. § 54.4975-11(b). Thus, every ESOP that intends to make its long-term investment exclusively in employer securities will contain the "primarily" language. Use of the word "primarily" preserves the ability to invest in alternative assets where, as discussed above, it is statutorily required for employees nearing retirement age, *see* 26 U.S.C. § 401(a)(28); where, as here, a portion of the assets are kept in short-term cash-equivalent investments in order to provide liquidity "for the payment of administrative expenses and cash distributions" (App. 7a); and where an ESOP forms only a portion of a plan, the balance of which contains investments that are fully subject to normal fiduciary rules, *see* 26 C.F.R. § 54.4975-11(a)(5). Use of the word "primarily" did not distinguish the Statewide ESOP from other ESOPs or suggest any intent that Plan assets be invested in other than Statewide stock, and the court below erred in so holding.

The court also erred in fashioning a rule based on trust law that the ESOP fiduciaries' conduct must be viewed in light of whether there are changed circumstances which warrant a variance from the settlor's original intent. That rule makes sense in a typical trust law situation where, for example, the settlor under a will is deceased and can no longer express a current intent. Under ERISA, however, the settlor of an employee benefit plan, *i.e.*, its corporate sponsor, retains the inherent power to modify or even terminate the plan at any time and for any reason.[8] Given that principle, there is no basis on which to subject ESOP fiduciaries to liability for either second-guessing, or failing to second-guess, the sponsor's stated intent to invest in employer securities. Rather, the sponsor itself can decide on an ongoing basis whether the ESOP continues to serve the purpose for which it was established and can act accordingly.

According to published statistics, approximately 9,500 ESOPs now exist in the United States and cover 11 million employees. *See Employee Stock Ownership Plans 1995 Yearbook* (Robert W. Smiley, Jr., *et al.*, eds., 1994) ¶ U.1. The tremendous growth in the number and scope of ESOPs has sprung directly from Congressional intent and incentives to foster ESOP investment in employer securities. By calling into question the lawfulness of ESOP investment in employer securities and threatening ESOP fiduciaries with

---

[8]*See, e.g., Siskind v. Sperry Retirement Program*, 47 F.3d 498, 505 (2d Cir. 1995); *Izzarelli v. Rexene Products Co.*, 24 F.3d 1506, 1524-25 & n.33 (5th Cir. 1994); *Hozier v. Midwest Fasteners, Inc.*, 908 F.2d 1155, 1161 (3d Cir. 1990) (collecting cases).

personal financial liability for choosing employer securities over other possible investments, the decision below runs counter to that Congressional intent. Accordingly, review by this Court and reversal of the decision below is appropriate.

CONCLUSION

For the foregoing reasons, the Court should grant a writ of certiorari on the question presented.

Respectfully submitted,

CHRISTOPHER J. CAREY
LISA W. SANTOLA
TOMPKINS, MCGUIRE & WACHENFELD
100 Mulberry Street
Newark, NJ 07102
(201) 622-3000

ROBERT N. ECCLES
Counsel of Record
KAREN M. WAHLE
O'MELVENY & MYERS
555 Thirteenth Street, NW
Washington, DC 20004
(202) 383-5300

Counsel for Petitioners

December 11, 1995